The ECB's Controversial Securities Market Programme (SMP) and its role in relation to the modified EFSF and the future ESM

by

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The article analyzes how the role of the European Central Bank (ECB) has developed throughout the sovereign debt crisis. The author concludes that the ECB acted, so far, within the limits of its competences. However, he recognizes that this judgment is built on a rather "aggressive" interpretation of the TFEU and the statute of the ECB. The author is very sceptical that the existence of the modified EFSF and ESM will allow the ECB to stop buying sovereign bonds in secondary markets. He outlines the structure of a potential future Fiscal Union including Eurobonds.

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I. Introduction

1. Outline of the legal questions related to the SMP

The Securities Market Programme (SMP) of the ECB was first established in May 2010 as an emergency reaction to the eruption of the Greek crisis followed by the Irish and the Portuguese crisis.[1] Subject to that programme the ECB purchased on the secondary market sovereign bonds issued by distressed Euro Area Member States. In the first half of the year 2011 the SMP came to a standstill, but was reactivated and extended in August 2011.[2] Only days after the ECB started for the first time to buy Spanish and Italian sovereign bonds, Ottmar Issing, one of the godfather of the Euro, wrote this harsh critic in the Financial Times[3]: "A monetary union with a stable euro can only survive if central bank independence is fully respected. This implies that the ECB abstains from fiscal policy actions (such as buying sovereign bonds in secondary markets). Yet to change the "no bail-out" clause ever more in the direction of a bail-out regime is not a step towards a democratically-legitimised political union."

From a legal perspective Issing's straight forward statement raises at least three fundamental questions: (1) Does the Securities Market Program (SMP) pose a serious risk to the independence of the ECB (Art. 130 TFEU)? (2) Does the SMP expose the Euro Area Member States to a bail out risk, thereby violating Art. 125 (1) TFEU? (3) Can the SMP result in a breach of the ban on monetary financing of governments (Art. 123 TFEU)?

Without addressing the much broader topic, whether or not the SMP was democratically legitimized and on the long run effective, one can hardly deny that the SMP is indeed threatening the ECB's independence. As a major sovereign creditor the independence of the ECB gets vulnerable in several ways.

1 Decision of the ECB of 14 May 2010 establishing a securities market programme (ECB/2010/0), Offical Journal EU, 20. 5. 2010 L 124/8 (http://www.ecb.int/ecb/legal/pdf/l_12420100520en00080009.pdf).

2 See http://www.centralbanknews.info/2011/08/european-central-bank-signals-expansion.html

3 Issing, Slithering to the wrong kind of Union, Financial Times, 8. 8. 2011 (http://www.ft.com/intl/cms/s/0/c4159b34-c1a8-11e0-acb3-00144feabdc0.html#axzz1mFeLpNbi); see also Issing, Die Währungsunion im Spannungsfeld von Politik und Ökonomie, EWS 2011, 257 ff.

In case of a sovereign default the ECB will face mounting political pressure to accept waivers and haircuts. This is not only a theoretical concern, but became reality in the first quarter of the year 2012, when the negotiations between Greece and its private creditors (basically financial institutions holding Greek bonds) about a voluntary haircut reached a decisive point. Influential economists like for instance Wolfgang Franz, who is a member of the government related German Council of Economic Expert[4] (hence a so-called "Wirtschaftsweiser"), called for a participation of the ECB in the debt restructuring process.[5] If such a participation will take place, and if the agreed "haircut" on the nominal value will reduce the ECB's real claim against Greece to an amount which is going to be lower then the price, the ECB paid when purchasing the original Greek bonds in the secondary market, than the bank will need to absorb significant losses. Furthermore, accepting such a deep haircut would result in a violation of the ban on monetary financing (Art. 123 TFEU).[6]

As a major creditor of distressed Euro Area Member States the ECB runs automatically into a conflict of interest: Like all creditors of sovereign bonds the ECB will have a natural interest in a strong economic performance of its debtor, hence it will appreciate if not foster high GDP growth and low unemployment rates. This interest causes naturally tensions with regard to the concept of the ECB as enshrined in Art. 127 (1) TFEU. Said sacrosanct rule determines a clear and simple target hierarchy for the ECB's monetary policy: first comes price stability! The ECB has no mandate to foster labour market performance or growth (on the expense of a higher inflation rate).

However, the sacrosanct policy target "price stability" is not only threatened by a potential conflict of interests caused by the SMP, but also by a moral hazard problem triggered by the very same programme. It is clear from the outset that monetary stability of the Euro Area depends on fiscal discipline of each and every member state. If the market for bonds of a specific sovereign issuer dries up, this will send a clear message to the respective member state: Restore investors' confidence via budget discipline and improved competitiveness or you will get no more refinancing ("rolling") of the accumulated debt load! The price of its bonds in the secondary market is the essential signal for the interest rate a bond issuer needs to offer when placing new bonds in the primary markets. Given the fact that sovereign bond issuers (almost) never pay back their debt load but just "roll" it into the future, their solvency depends on the ability to constantly place new bonds in the primary market (ideally at

4 http://www.sachverstaendigenrat-wirtschaft.de/index.html?&L=1

5 http://www.deutsche-mittelstands-nachrichten.de/2012/01/37140/

6 See below II 2 and Atkins, Financial Times 16. 11. 2011, ECN under strain as political masters bicker (http://www.ft.com/intl/cms/s/0/402b158c-1073-11e1-8298-00144feabdc0.html#axzz1mFeLpNbi)

favourable conditions). Consequently secondary markets have a disciplining effect on politicians.

But if politicians of a sovereign debtor, who is used to lax fiscal discipline, can rely on the assumption that the ECB will step in as a buyer of last resort, the reform pressure exerted by market forces will diminish and politicians of the over-indebted state will continue to spend above the level of national tax revenues. We all remember that only days after the ECB began to buy for the first time Italian bonds in summer 2011 the government of Ex-President Berlusconi started to relax the previously promised austerity programme.[7]

However, from a legal point of view it is very difficult to make a judgement on whether or not the institutional guarantee[8] of central bank independence has been violated by a specific monetary policy measure taken by the central banks itself. Raising this question poses in itself a challenge to central bank independence. Central banks must enjoy a huge leeway[9] – particularly in an unprecedented crisis – and should not be policed by turning their institutional guarantee of independence into a judicial corrective. Therefore this article will focus on the second and third question raised by Issing. Hence it will be discussed if the SMP creates a severe bail-out risk conflicting with Art. 125 (1) TFEU. Furthermore it will be analysed if the permanent European Stability Mechanism (ESM) – as agreed in January 2012[10] – is capable to free the ECB from such a potential bail-out risk and the need to act itself as a sovereign bond purchaser of last resort.

2. *From the EFSF to the ESM*

The European Financial Stability Facility (EFSF) was created by the euro area Member States following a decision taken on May 9, 2010 within the framework of the Ecofin Council. The EFSF's mandate is to safeguard financial

7 Atkins, Eurozone crisis: A deft to buy time, Financial Times, 7.2.2012 (http://www.ft.com/intl/cms/s/0/a7ade85e-5184-11e1-a99d-00144feabdc0.html).

8 See Zilioli/Selmayr, The Constitutional Status of the European Central Bank, CML Rev. 2007, 355–399.

9 In order to get an idea of how the ECB interprets the independence rule see for instance ECB Opinion of 1 July 210 on the remuneration of the staff of Banca Nationala a Romaniei (CON/2010/51); ECB Opinion of 25 March 2010 on independence, confidentiality and the prohibition of monetary financing (CON/2010/25); ECB Opinion of 14 July 2009 on the taxation of Banca d'Italia's gold reserves (COM/2009/59); ECB Opinion of 18 May 2009 on measures on public sector remuneration with regard to central bank independence (COM/2009/47); see also Zilioli/Selmayr, The Constitutional Status of the European Central Bank, CML Rev. 2007, 355, 368–368.

10 See http://www.efsf.europa.eu/attachments/esm_treaty_en.pdf

stability in Europe by providing financial assistance to Euro Area Member States.[11] The Facility was established in an emergency reaction to the eruption of the Greek crisis, followed by the Irish and the Portuguese crisis. Originally it has been equipped with a limited volume and few intervention tools. Basically the EFSF was empowered to grant loans to troubled states which rank pari passu with private sector claims.[12] Intervention in securities markets was not part of the original tool box.

However, it was clear from the outset that the EFSF would serve as an interim solution only. Particularly the German government insisted on a mechanism that would include private sector involvement.[13] Hence the Euro Area Member States soon started to design the ESM which should become a permanent European institution. At that time it was planned that the ESM will replace the EFSF from 2013 on.[14] But the dynamics of the crisis forced the Eurozone Member States to reform even the interim solution, the EFSF, only one year after its establishment.[15] The reform became effective in autumn 2011. Since then the EFSF is empowered to intervene in primary and/or secondary markets for sovereign bonds. Intervention in the secondary market can only take place on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability.

On the occasion of their 2012 January summit the Euro Area Member States singed the ESM-Treaty, the basis for a permanent European rescue fund.[16] Given the depth of the sovereign debt crisis and the insufficiency of funds provided by the EFSF, the contracting states agreed to pre-pone the operational start of the ESM from 2013 to mid 2012. In the light of the ongoing discussion to increase the funds of the ESM it is likely that ESM Member States will decide on the occasion of their next summit in March 2012 to run both rescue funds simultaneously. Previously it was planned that the ESM will replace the EFSF. Concerning the sovereign bond market the new ESM will have similar intervention rights as the reformed EFSF. Consequently the rescue funds, should at least theoretically be able to replace the ECB's controversial SMP.

Both rescue funds are based on intergovernmental agreements, hence international treaties. The funds are established as sociétés anonymes in Luxemburg with full legal capacity but without a bank license. The rational for the shift

11 http://www.efsf.europa.eu/about/index.htm

12 See the introduction to the functioning of the EFSF by Regling, Aufgaben und Herausforderungen des EFSF, EWS 2011, 261 ff.

13 Sester, Beteiligung von privaten Investoren im Rahmen des ESM, WM 2011, 1057 ff.

14 European Council, EUCO 10/11 of 20. 4. 2011 (http://register.consilium.europa.eu/pdf/de/11/st00/st00010-re01.en11.pdf).

15 European Council, 24/25 March 2011, EUCO 10/11, Co EUR 6, CONCL 3, p. 6

16 See http://www.efsf.europa.eu/attachments/esm_treaty_en.pdf

towards an intergovernmental organization instead of creating a new European institution (established on the basis of the European Treaties) has been the lack of time to amend the treaties and the political risk inherent in each alteration of the treaties. The latter has been considered by many governments to be particularly high in the face of the current severe crisis and a furious population. However, what seemed to be a politically the unavoidable second best solution disclosed its shortcomings very fast if not right from the start. When it became necessary to redesign the EFSF-Agreement only one year after its conclusion, it turned out that the necessary consent of all 17 parties to the treaty (particularly the approval by national parliaments) was almost as difficult to achieve as an amendment of the European Treaties (TEU/TFEU). Furthermore the institutional shift has given rise to at least two fundamental concerns: (1) the unclear relation between the rescue funds on the one side and the existing EU institutions and the provisions of the European Treaties on the other side; (2) the lack of democratic control on the EU level. The first concern will be addressed in detail. The latter one is part of the broad and challenging task to design a legitimized Fiscal Union for the post crisis world; a topic that can only be outlined at the end of this article.

3. Policy change by Mario Draghi: focusing on LTRO instead of increasing SMP

The most significant policy change Mario Draghi made short after he had followed Jean Claude Trichet as president of the ECB was the launch of two massive Longer Term Refinancing Operations (LTRO).[17] Draghi's idea has been to make an unprecedented offer to the banks of cheap (but secured) loans lasting three years in any quantities they liked. The aim was to provide "a wall of money" to shield the banking system from a liquidity crunch. According to Financial Times journalist Ralph Atkins, the assumption or hope that Euro Area banks might use the funds to invest in high-yield bonds of distressed governments was discussed on various occasions by council members but was not part of the official justification.[18] The LTROs were announced on December 8, 2011.[19] The first operation was completed on December 20, 2011 and the second one will be completed on February 28, 2012. The total allotment of three-years loans during the first LTRO amounted to € 489bn (equivalent to 5 per cent of eurozone cross-domestic product).

17 See Linzert/Nautz/Bindseil, The Longer Term Refinancing Operations of the ECB, ECB Working Paper Series NO. 359/May 2004 (http://www.ecb.int/pub/pdf/scpwps/ecbwp359.pdf).

18 Atkins, Eurozone crisis: A deft way to buy time, Financial Times, February 8, 2012, p. 7.

19 ECB Press Release, 8 December 2011 (http://www.ecb.eu/press/pr/date/2011/html/pr111208_1.en.html).

Given the fact that banks can only participate in LTRO as along as they can offer sufficient eligible assets as collateral the ECB combined its announcement of the three-years LTROs with a change of collateral rules[20]: First the rating threshold for certain asset-backed securities (ABS) has been reduced, and second the ECB has been allowing national central banks (NCBs), as a temporary solution, to accept as collateral additional performing credit claims (i.e. bank loans) that satisfy specific eligibility criteria.[21] On February 9, 2012 the ECB published the information that the ECB's Governing Council has approved, for the seven NCBs (Ireland, Spain, France, Italy, Cyprus, Austria and Portugal) that have put forward relevant proposals, specific national eligibility criteria and risk control measures for the temporary acceptance of additional credit claims as collateral in Eurosystem credit operations.[22] Subject to the ordinary collateral rules only assets with a probability of default of less than 0.4% are qualified as eligible assets, seven NCBs are no accepting (at least for the next 12 months) also assets with a probability of default up to 1% or even 1.5%. As a consequence of this change an additional amount of EUR 600 to 700bn assets could be offered as collateral in the second LTRO round. However, ECB President Mario Draghi announced in a press conference on February 9, 2012 that the haircut (or over-collateralisation) applied to the riskier assets will be much higher as in the ordinary case. The haircut could amount up to 2/3 of the nominal/market value, reducing the additional borrowing capacity to EUR 200bn.[23] The downside of the new scheme, from the

20 ECB-Decision of 14 December 2011 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral (ECB/2011/05).

21 ECB Press Release of 8 December 2011 – ECB announces measures to support bank lending and money market activity (http://www.ecb.eu/press/pr/date/2011/html/pr111208_1.en.html); ECB-Decision of 14 December 2011 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral (ECB/2011/05), Art. 4 (1) An NCB may accept as collateral for Eurosystem monetary policy operations credit claims that do not satisfy the Eurosystem eligibility criteria. (2) The NCBs shall establish eligibility criteria and risk control measures for accepting credit claims pursuant to paragraph 1. Such eligibility criteria and risk control measures shall be subject to prior approval by the Governing Council.

22 ECB Press Release of 9 February 2012 – ECB's Governing Council approves criteria for additional credit claims (http://www.ecb.europa.eu/press/pr/date/2012/html/pr120209_2.en.html); see also Introductory statement to the press conference (with Q&A) and transcript of the questions asked and the answers given by Mario Draghi, President of the ECB, and Vítor Constâncio Vice-President of the ECB, 9 February 2012 (http://www.ecb.int/press/pressconf/2012/html/is120209.en.html).

23 Introductory statement to the press conference (with Q&A) and transcript of the questions asked and the answers given by Mario Draghi, President of the ECB, and Vítor Constâncio Vice-President of the ECB, 9 February 2012 (http://www.ecb.int/press/pressconf/2012/html/is120209.en.html): "if I am not mistaken (...), we have from about 600 to 700bn euro as the estimated amount of credit claims, of which only 200bn euro

perspective of the seven NCBs applying the weaker standard, is that these NCBs will have to bear the additional credit risks (default and loss given default) directly themselves. Hence, if a bank that has borrowed money from the ECB goes into default and losses are incurred, there will be no sharing of burden with other NCBs of the Euro Area.[24]

The move from the controversial SMP to massive LTROs has, at least from a strategic perspective, a clear advantage for Mr. Draghi and the majority of the ECB's Governing Council: When conducting LTROs the ECBs is acting straight forward as a liquidity provider of last resort for the banking sector, which is a role that clearly falls within the competences and responsibilities of the ECB. Consequently Mr. Draghi could escape the continuous critic of the German central bank (Deutsche Bundesbank) which saw the SMP right from the start as a move to break a rule which has been sacrosanct for generations of German central bankers: the ban on central banks financing governments (Art. 123 TFEU). However, excessive lending to private banks in combination with relaxed collateral rules obviously increases the risks of the ECB, NCBs and their owners. Furthermore "too generous" liquidity provisions could create the wrong incentives for euro area banks, storing up inflation risks for the future.[25] And if banks participating in the LTROs are investing the extra liquidity in high-yield bonds of distressed governments, which they use subsequently in reversed transaction or as collateral in new credit transactions with the ECB, it becomes evident that the LTROs have very similar effects on the balance sheet of the ECB as the SMP. In fact, the described mechanism can be classified as backdoor leveraging.[26]

Anyway, changing the focus to LTROs does not mean that the SMP is history. First of all it was never officially terminated and can be increased any time. And second, the already purchased sovereign (junk) bonds are still there spoiling the ECB's balance sheet.

plus would become acceptable, because of the strong over-collateralisation we ask for."; see also Proissl, EZB begrenzt Risiken aus Bankenhilfe, Financial Times Deutschland, 10. 2. 2012 (http://www.ftd.de/print-archiv/artikel/2028192?mode=print).

24 See Atkins, Eurozone crisis: A deft way to buy time, Financial Times, February 7, 2012, p. 3.

25 Atkins/Watkins, Germans concerned over Drahi liquidity offer, 9. 2. 2012 (http://www.ft.com/intl/cms/s/0/f7a0b748-5345-11e1-aafd-00144feabdc0.html).

26 See below II 1.

II. Does the SMP create a bail out risk contrary to Art. 125 (1) TFEU?

1. SMP – recapitalisation of the ECB – "backdoor" bail-out

For the time being it is too early to predict the long term financial consequence of the SMP for the ECB. So far one can only make a rather trivial statement: the ultimate financial result of the bond-buying programme will depend on the future of the bond issuers. If the issuing countries will be able to pay interests and principle without a dept restructuring programme (including haircuts on outstanding principal, direct or indirect interest cuts resulting from a prolongation without an increase of the interest rate) then the ECB and its owners, the Euro Area Member States, are safe. In this case the ECB can either re-sell the bonds in the market or hold them to maturity. Both options may even result in a net profit if the respective issuers return to a sustainable fiscal path and investors regain trust.

But if the issuer can not return to such a sustainable path without a tough dept restructuring programme including haircuts or prolongation of maturity then the ECB will suffer losses. Subject to the ECB-Statute such losses will be absorbed by using the general reserve fund (Art. 33.1 ECB-Statute). If not sufficient its monetary income, hence the ECB's currency reserves will be used. Ultimately member states will need to recapitalize the ECB. Although some economists state that (classical) central banks may operate perfectly well without capital as conventionally defined they concede that a large negative net worth, is likely to compromise central bank independence and interfere with its ability to attain policy objectives.[27] If society values an independent central bank capable of effectively implementing monetary policy, as it is common conviction in Europe, central bank recapitalization may become essential.[28] The latter should be particularly true with regard to the unique legal nature of the ECB, which is a kind of "stock corporation" owned by sovereign shareholders, the Member States of the Euro Area (Art. 28 ECB-Statute).

If the necessity to recapitalize the ECB arises as a direct consequence of the SMP in combination with a following voluntary debt restructuring, such re-

27 Stella, ILF Working Paper WP/97/83, Do Central Banks Need Capital?, 2005 http://www.perjacobsson.org/external/pubs/ft/wp/wp9783.pdf; for recommendations on how recapitalization of central banks can ce done in practice see Dalton/Dziobek, IMF Working Paper WP/05/72, Central Bank Losses and Experiences in Selected Countries.

28 Stella, ILF Working Paper WP/97/83, Do Central Banks Need Capital?, 2005 http://www.perjacobsson.org/external/pubs/ft/wp/wp9783.pdf; for an example of a central bank recapitalization law see Law No. 167-07 for the Recapitalization of the Central Bank of the Dominican Republic http://www.creditopublico.gov.do/ingles/Legal%20Framework/law/Recapitalization%20Law_167-07.pdf

capitalization can be qualified (at least) as a "backdoor" bail-out and indirect monetary financing of governments. The attribution of a bail-out risk to SMP is not only a theoretical perception. In contrast, it is a matter of fact that could be clearly observed in the sovereign bond markets during the crisis. Immediately after the ECB reactivated the SMP in Mid-2011, the prices for Credit Default Swaps for 5 years German bonds rose significantly.[29] The rise was even stronger in the case of Credit Default Swaps for the equivalent French bonds.[30] CDS yields for 5 years sovereign bonds are widely considered as a good indicator for medium term country risk.[31] Hence, there is empirical evidence for the statement that, subject to market perception, the SMP poses indeed a de facto bail out risk.

2. *Legal basis for the SMP*

According to the decision of the ECB on the establishment of the SMP its legal basis is rooted in these articles of the Treaty on the Functioning of the European Union and the ECB-Statute:

Art. 127 (2) TFEU (equivalent to Art. 3.1 ECB-Statute):

The basic tasks to be carried out through the ESCB shall be: – to define and implement the monetary policy of the Union (…).

Art. 12.1 (2) ECB-Statute:

The Executive Board shall implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so the Executive Board shall give the necessary instructions to national central banks. (…)

Art. 18.1 ECB-Statute:

In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may: – operate in the financial markets by buying and selling outright (…).

As a matter of fact Art. 18.1 ECB-Statute empowers the ECB to buy and sell outright securities in financial markets if these transactions help to achieve the objectives of the ECB, hence help to implement the monetary policy as defined by the ECB's Governing Council. When taking its decision to launch the SMP in May 2010, the ECB consequently brought forward the argument that intervention in secondary markets is justified whenever tensions in those markets are hampering the monetary transmission mechanism

29 http://m.faz.net/aktuell/finanzen/anleihen-zinsen/kreditversicherungen-praemien-deutscher-papiere-steigen-stark-11115152.html

30 http://m.faz.net/aktuell/finanzen/anleihen-zinsen/kreditversicherungen-praemien-deutscher-papiere-steigen-stark-11115152.html

31 See ECB Financial Stability Review, June 2011, pp. 72–73.

and thereby the effective conduct of monetary policy.[32] This argument is solid because the ECB-Statute explicitly empowers the ECB to pursue intermediate monetary objectives (Art. 12.1 ECB-Statute), for instance the smooth functioning of the monetary transmission mechanism. When the ECB decided to reactivate the SMP in summer 2011 its argumentation remained basically the same.

But given the clear hierarchy of its policy objectives, as enshrined in Art. 127 (1) TFEU, the ECB must assure that conducting intermediate monetary policy objectives does not have a negative impact on price stability. For price stability is clearly the per-dominant monetary objective. Only if price stability is not going to be negatively effect, shall the ECB support the general economic policies of the European Union (Art. 2 ECB-Statute). However, it is clear from the outset that each sovereign bond-buying programme of a central bank extents the total amount of money in circulation if no effective counter measure is taken. That is why the Federal Reserve calls its bond-buying program "Quantitative Easing".[33] The extra liquidity spread by such programmes puts price stability, the primary objective of the ECB, naturally at a certain risk. The ECB is of course aware of this effect. Therefore it underlines – although not in its formal decision on the SMP[34] – that it will "sterilise" the extra liquidity by withdrawing an equivalent amount of liquidity from money markets every week it will buy sovereign bonds.[35]

How can the ECB assure such sterilisation? In order to answer this question we need to have a closer look at the bunch of permitted monetary operations. The ECB's tool box is regulated in its statute (Art. 17–24 ECB-Statute[36]) and divided into standard and non-standard operations. Sovereign bond-buying can only be qualified as a non-standard measure by which the ECB acts as a liquidity provider of last resort for sovereign bond markets. The standard operations comprise open market and credit transactions. Here the ECB acts as a liquidity provider of last resort for banks. With regard to the governance

32 Decision of the ECB of 14 May 2010 establishing a securities market programme (ECB/2010/0), Offical Journal EU, 20.5.2010 L 124/8 (http://www.ecb.int/ecb/legal/pdf/l_12420100520en00080009.pdf).

33 See http://www.guardian.co.uk/business/2011/aug/26/bernanke-jackson-hole-speech-qe

34 Decision of the ECB of 14 May 2010 establishing a securities market programme (ECB/2010/0), Offical Journal EU, 20.5.2010 L 124/8 (http://www.ecb.int/ecb/legal/pdf/l_12420100520en00080009.pdf).

35 Peel/Milne, Bond move deepens EBC divide, FT August 7, 2011 (http://www.ft.com/intl/cms/s/0/70dbb426-c103-11e0-b8c2-00144feabdc0.html#axzz1mFeLpNbi).

36 The possible operations and instruments are specified in Guidelines of the ECB of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem, Official Journal EU, 14.12.2011, L 331/1.

of short term liquidity open market transactions and the standing facilities are essential. Open market operations are initiated by the ECB, which also decides on the instruments to be used and on the terms and conditions for its execution. The standing facility works different. Here, the financial institutions take the initiative if they need the ECB as a provider of overnight liquidity. Under normal circumstances, there are no credit limits or other restrictions on counter-parties' access to the facility apart from the requirement to present sufficient underlying assets. All these operations have the effect to extend the total mount of money in circulation.

So how can the ECB withdraw liquidity from money markets? On a weekly basis, there are basically two ways to reduce the extra liquidity generated by the bond-buying programme. The ECB can (theoretically) reduce the tender volume of the main refinancing instrument and/or it can collect fixed term deposits. The latter is qualified as a fine tuning operation in the terms of the Guidelines of the ECB on monetary policy instruments and procedures of the Eurosystem.[37] Confronted with a disturbed interbank market the ECB uses basically the second way to absorb the extra liquidity generated by means of buying sovereign bonds in secondary markets. So far this strategy has been working pretty well. Due to the lack of confidence among private banks the interbank market for cash deposits dried up and consequently the demand for central bank cash deposits is huge.

However, there is no guarantee how long and to what extend this previously untested ECB intervention will work. Despite the strong opposition from (Ex) German central bankers, particularly Otmar Issing[38], Axel Weber[39] and

37 See ECB/2011/14, No. 1.131 (c), Official Journal EU, 14. 11. 2011, L 331/1 (http://www.ecb.int/ecb/legal/pdf/l_33120111214en000100951.pdf)

38 Issing, Slithering to the wrong kind of Union, Financial Times, 8. 8. 2011: "A monetary union with a stable euro can only survive if central bank independence is fully respected. This implies that the ECB abstains from fiscal policy actions *(such as the SMP)*. Yet to change the "no bail-out" clause ever more in the direction of a bail-out regime is not a step towards a democratically-legitimised political union. (...) The implied transfer of taxpayers' money would also take place without the involvement of national parliaments – a clear violation of the fundamental democratic principle "no taxation without representation". http://www.ft.com/intl/cms/s/0/c4159b34-c1a8-11e0-acb3-00144feabdc0.html#axzz1mBilTevU

39 Weber, Monetary policy after the crisis: A European perspective, 12. 10. 2010: "There is no evidence that asset purchases have had any significant impact on average euro-area sovereign bond yields on which euro-area monetary policy must exclusively focus as its main transmission channel. But the SMP risks blurring the different responsibilities between fiscal and monetary policy. As the risks associated with the SMP outweigh its benefits, these securities purchases should now be phased out permanently as part of our non-standard policy measures." (http://www.bundesbank.de/download/presse/reden/2010/20101012.weber.somc.en.php).

Jürgen Stark[40], but also current Bundesbank President Jens Weidemann[41], one has to concede that the large majority of the ECB's Governing Council repeatedly voted in favour of the SMP. It follows from the ECB's independence and its decision making process, as laid down in the ECB statute, that the institution as such enjoys a kind of "business judgment rule" when taking monetary policy decision. In the light of this rule, which is derived from the principle of independence, it seems appropriate to conclude that the SMP can in deed be justified on the basis of Art. 127 (2) TFEU, Art. 12.1 (2) and Art. 18.1 ECB-Statute.[42] However, if the ECB will – for whatever reason – re-sell the purchased sovereign bonds at a loss to the EFSF, the ESM or the issuer this would have to be considered as monetary financing.[43]

Not surprisingly, the President of the ECB and the majority of its Governing Council did not feel comfortable with its controversial SMP. It was considered

40 Elliot, ECB reveals 22bn cost of bond rescue, The Guardian, 15. 8. 2011: "The ECB reactivated its securities market programme (SMP) after leaving it dormant for 19 weeks, despite opposition from a group on the bank's policymaking governing council, led by Germans Jens Weidmann and Jürgen Stark." (http://www.guardian.co.uk/business/2011/aug/15/european-central-bank-bonds); see also "The European Central Bank – Ready for the ruck?, The Economist, 22. 10. 2011 (http://www.economist.com/node/21533368) and http://www.reuters.com/article/2011/11/08/us-ecb-weidmann-idUSTRE7A74G120111108.

41 Atkins/Sandbu, FT Interview Transcript: Jens Weidmann, 13. 11. 2011: "The ECB Governing Council has always stressed that the Securities Markets Programme is about ensuring the monetary policy transmission process. But it comes with risks. The risks are reflected in our balance sheet. There's also a risk that you mute the incentives that come from the market. Recent experience has shown that market interest rates do play a role in pushing governments towards reforms. You have seen that in the case of Italy quite clearly. We have a mandate and we have to stick to our mandate. Fixing an interest rate for a country is certainly not compatible with our mandate. You would guarantee a certain refinancing cost for a government and you could not argue that this was not monetary financing. The stated purpose of the SMP is to cope with dysfunctional markets and it's not to ensure a specific spread for a specific country." (http://www.ft.com/intl/cms/s/0/b3a2d19e-0de4-11e1-9d40-00144feabdc0.html#axzz1mBoB3GTD)

42 Same conclusion is taken by Herrmann, EZB-Programm für die Kapitalmärkte verstößt nicht gegen die Verträge EuZW 2010, 645; different but with poor and polemic arguments Seidel, Der Ankauf nicht markt- und börsengängiger Staatsanleihen, namentlich Griechenlands, durch die Europäische Zentralbank und durch nationale Zentralbanken – nur rechtlich fragwürdig oder Rechtsverstoß?, EuZW 2010, 521.

43 Mario Draghi, Introductory statement to the press conference (with Q&A) and transcript of the questions asked and the answers given by Mario Draghi, President of the ECB, and Vítor Constâncio Vice-President of the ECB, 9 February 2012 (http://www.ecb.int/press/pressconf/2012/html/is120209.en.html): "It depends, if you make a loss on the sales (to the FSFS which he sates is "like a government") that is monetary financing."

rather as an inevitable evil than a second best policy tool. Therefore Jean Claude Trichet exerted in summer 2011 a lot of pressure on Euro Area Member States to construct the permanent ESM and reform the EFSF in such a way that the two rescue funds are empowered to intervene directly in secondary sovereign bond markets. In one of his last press conferences as ECB President Mr. Trichet said on 4th August 2011[44]: "Of course, what we expect is that the EFSF, which will have the capacity to intervene in the secondary markets, will be effective and efficient in its interventions. That would permit us not to have to intervene to help restore more appropriate monetary policy transmission."

III. The ECB's role in relation to the modified EFSF and the future ESM

1. The legal basis of the EFSF and the ESM

The legal basis of the EFSF and the ESM was created in March 2011 through a European Council Decision amending Art. 136 TFEU.[45] The amendment is based on Art. 48 (6) TEU which allows the European Council, acting by unanimity after consulting the European Parliament, the Commission and, in certain cases, the European Central Bank, to adopt a decision amending all or part of the provisions of Part Three of the Treaty on the Functioning of the European Union (TFEU). Subject to the amendment the following paragraph was added to Article 136 TFEU: "3. The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the *stability of the euro area as a whole*. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

Although the amendment was specifically designed to provide a legal justification in EU primary law it is questionable if this has been done in a legitimised way. Given the fact that both, the EFSF and ESM, are creating new financial obligations for the Member States of the Euro Area, that have no other objective then to help Euro Area Member States in financial distress, one can hardly deny that this is conflicting with the original idea of the no bail out clause (Art. 125 TFEU).[46] This conflict caused by the amendment of the TFEU

44 Transcript of the questions asked and the answer given by Jean Claude Trichet, President of the ECB, 4. 8. 2012 (http://www.ecb.int/press/pressconf/2011/html/is110804.en.html).

45 European Council Decision of 25 March 2011 (2011/199/EU) Official Journal of the EU, 6. 4. 2011, L 91/1.

46 However Art. 125 TFEU cannot be interpreted as a prohibition of financial assistance granted to a Euro Area Member State. Although this is widely and clearly accepted there are some isolated opponents like Seidel, Die "No-Bail-Out"-Klausel des Art. 125 AEUV als Beistandsverbot, EuZW 2011, 529–530.

appears particularly problematic when taking into consideration that the simplified process to amend the TFEU, offered by Art. 48 (5) TEU, can not be used to increase the competences conferred on the Union in the Treaties. However, from a purely technical point of view neither the treaties establishing/modifying the EFSF nor the treaty establishing the ESM confer new competences on institutions of the EU because both rescue funds stand outside EU primary law. However, it is clear from the outset that they both have a severe impact on the functioning of the Monetary Union. In fact they deepen that Union and pave the way to a Fiscal Union. Consequently the rescue funds, particularly the permanent ESM, should be converted, as soon as possible, into a permanent institution established and regulated within the TFEU. The current design as a intergovernmental institution outside primary law does not fit into the institutional setting of the European Union. The logical consequences are political and legal (if not juridical) conflicts about the relationship between the rescue fund and the existing institutions of the European Treaties and its provisions.[47]

One can go even one step further and raise the following question: If the ESM is not a European institutions in the sense of the TEU and the TFEU why do we need the new Section 3 of Article 136 TFEU? Well, in my opinion simply because Euro Area Member States wanted to have a pro forma legal justification for the de facto violation of the no bail out clause. In order to return to a consistent and legitimised legal framework for the existing Monetary Union as well as for the emerging Fiscal Union it is indispensible to continue struggling for a classical long-track reform of the European Treaties which aims to integration the permanent rescue fund into the ordinary institutional setting.

2. The ECB's function under the reformed EFSF-Agreement and the ESM-Treaty

Subject to Art. 13 (1) ESM-Treaty the procedure for granting stability support to an ESM Member starts as such: "the Chairperson of the Board of Governors (of the ESM) shall entrust the European Commission, *in liaison with the ECB*, with the following tasks: (a) to assess the existence of a *risk to the financial stability of the euro area as a whole* or of its Member States, unless the *ECB* has already submitted an analysis under Article 18(2)."

Consequently the ECB is involved in the initial decision on whether or not the key trigger event "risk to the financial stability of the euro area as a whole" as contained in Art. 136 (3) TFEU is fulfilled. The wording "in liaison" confers to

47 For the position of UK Prime Minister David Cameron see http://www.bbc.co.uk/news/uk-politics-16807226

the ECB a stronger position than the ordinary right to be consulted[48]: the ECB and the Commission are put on equal food print and consequently can only decide on the basis of a consensus on the existence of the specified risk level. If the essential precondition, the specified risk level, is given and the ESM decides to arrange for operations on the secondary market in relation to bonds of an ESM Member State, the role of the ECB becomes even more prominent. Art. 18 (2) ESM-Treaty states that the decisions to address contagion through secondary market intervention shall be taken on the basis of an analysis of *the ECB recognising the existence of exceptional financial market circumstances* and risks to financial stability. Hence, it is the ECB only who decides on this issue. The intervention mechanism under the reformed EFSF Framework Agreement looks basically the same.[49]

Consequently it is the ECB, who can pull the trigger for secondary market intervention. This key function is a logical consequence of the emergence of the EFSF-Reform and the ESM-Treaty. Originally it was not planned to give the modified EFSF and the ESM the power to intervene in secondary markets, just primary market intervention was on the agenda. It was only after continuous pressure from the ECB that the Member States of the Euro Area agreed on the occasion of their July 2011 summit to add secondary market intervention to the toolbox of the rescue fund. That explains why Mr. Trichet highlighted this feature of the institutional reform during the ECB's first press conference after the summit. He stated that the revised EFSF (and the ESM) will replace the ECB's bond-buying programme.[50] And indeed, the described mechanism of the up-graded EFSF- and the new ESM-Treaty, correspond to Mr. Trichet's statement. Theoretically the EFSF and ESM are enabled to substitute the ECB as liquidity provider of last resort for the sovereign bond markets while the ECB retains the power to free or veto such an intervention.

48 Zilioli/Selmayr, The Constitutional Status of the European Central Bank, CML Rev. 2007, 355, 381–386.

49 See Preamble 2: "purchase of bonds in the secondary markets on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability or facilities for the purchase of bonds in the primary market", and Art. 2 (1) (b): "Financial Assistance to a euro-area Member State may consist of facilities for the purchase of bonds in the secondary market to avoid contagion, on the basis of an ECB analysis recognising the existence of exceptional financial market circumstances and risks to financial stability or by way of facilities for the purchase of bonds in the primary market." (http://www.efsf.europa.eu/attachments/20111019_efsf_framework_agreement_en.pdf).

50 Transcript of the questions asked and the answer given by Jean Claude Trichet, President of the ECB, 4. 8. 2012 (http://www.ecb.int/press/pressconf/2011/html/is110804.en.html).

However, at least three important questions remain open: Will the modified EFSF and/or the ESM clean up the ECB's balance sheet? What happens if the EFSF and the ESM turn out to be too small? Are we on the way to an illegal bail-out regime?

3. *Will the ESM/EFSF clean up the ECB's balance sheet?*

Theoretically the ESM and/or the EFSF could buy sovereign bonds from the ECB and thereby clean up the bank's balance sheet that has been spoiled with sovereign "junk bonds" in the course of the SMP. But both, the modified EFSF-Treaty and the new ESM-Treaty, are silent on this issue. And given the limited resources of the rescue funds it seems very unlikely that the funds will purchase sovereign junk bonds from the ECB in order to clean up its balance sheet. In contrast, the ECB might be forced to participate in a "voluntary" haircut that will be arranged for the sovereign bonds of Greece.[51] Hence, the risk created by the SMP is likely to materialise for the ECB and its owners, the Member States of the Euro Area.[52]

4. *What happens if the EFSF and the ESM turn out to be too small?*

As a matter of fact, neither the enlarged EFSF nor the ESM, as established by the ESM-Treaty signed on January2012, have sufficient funds to shield Italy and/or Spain. This lack of firepower was evident from the outset and clearly addressed by the President of the IMF.[53] Consequently the ESM Member States agreed to incorporate a "fine tuning" clause in the ESM-Treaty. Recital (6) of the ESM-Treaty states[54]: "The initial maximum lending volume of the ESM is set at EUR 500 000 million, including the outstanding EFSF stability support. The adequacy of the consolidated ESM and EFSF maximum lending volume will, however, be reassessed prior to the entry into force of this Treaty. If appropriate, it will be increased by the Board of Governors of the ESM, in accordance with Article 10, upon entry into force of this Treaty." Referring to this clause several representatives of ESM Member States announced, when signing the ESM-Treaty in January, that on the occasion of their next summit

51 See http://www.welt.de/wirtschaft/article13855765/Griechen-Umschuldung-kostet-Deutsche-25-Milliarden.html

52 See above II 1.

53 See http://www.ft.com/intl/cms/s/0/52dcc61a-459f-11e1-93f1-00144feabdc0.html#axzz1mFeLpNbi and http://www.sueddeutsche.de/wirtschaft/iwf-chefin-fordert-aufstockung-des-esm-lagarde-setzt-merkel-unter-druck-1.1264793

54 See http://www.efsf.europa.eu/attachments/esm_treaty_en.pdf.

in March, 2012 it could already be decided that the EFSF and the ESM will operate parallel in order to raise the total amount of available rescue funds. Due to the lack of politically realistic alternatives to increase the funds, this dualism seems to be a probable scenario.

A possible alternative could be to leverage the equity capital of ESM through a banking licence. This idea was discussed extensively in autumn 2011, but was rejected by several Euro Area Member States, particularly by Germany. At least for the moment (beginning of 2012) this idea disappeared from the agenda. Turning the ESM into a bank would allow the permanent recue fund to engage in reversed or secured transactions with the ECB. By using sovereign bonds bought in the primary or secondary market as collateral the ESM could easily multiply its funds, because the security threshold (called haircut or over-collateralisation) on sovereign bonds used as collateral in reversed or secured transactions is low.[55] However, such leverage techniques would result in a huge risk for the ECB and misuse it for the financing of governments. The ECB itself highlights this potential misuse in its Opinion on the draft European Council Decision amending Art. 136 TFEU[56]: "With respect to the role of the ECB and the Eurosystem (. . .) Article 123 TFEU would not allow the ESM to become a counterparty of the Eurosystem under Article 18 of the Statute of the ESCB. On this latter element, the ECB recalls that the monetary financing prohibition of Article 123 TFEU is one of the basic pillars of the legal architecture European Monetary Union (EMU) both for reasons of fiscal discipline of the Member States and in order to preserve the integrity of the single monetary policy as well as the independence of the ECB and the Eurosystem".

A second possible alternative to raise the firepower of the ESM could be an increase of its capital. But taking the current political climate into consideration it does not seem very likely that all national parliaments of the ESM Member States would agree on such an additional increase of their contribution to the ESM.

Therefore running the EFSF and the ESM parallel seems to be the only available way to generated volume. The maximum amount of rescue funds that can be generated by this way will amount roughly to €750bn. As a matter of fact,

55 In the case of sovereign bond (fixed coupon) with a rating in the range of AAA to A- (Category I) and a residual maturity between 3 to 5 years the "haircut" applied in a reversed transaction is only 2.5% calculated on the basis of the market value. See Guidelines of the ECB of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem, Official Journal EU, 14. 12. 2011, L 331/1, 47–48.

56 ECB Opinion of 17 March 2011 on a draft European Council Decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro (CON/2011/24), Nr. 9.

even this sum will not be – at least in the perception of market participants – enough to shield Italy. Eventually it will even be too small for Spain. Consequently if bond yields for these two countries will sharply rise (at the same time) and the increased prices turn out to be robust, the ECB will once again get under pressure to intervene itself effectively in secondary markets. Hence, the establishment of the ESM is no guarantee against a revival of the SMP.

5. Does the ESM create an illegal bail-out regime?

Subject to Art. 8 ESM-Treaty the authorised capital stock of the ESM shall be EUR 700bn. It shall be divided into seven million shares, having a nominal value of EUR 100 000 each, which shall be available for subscription according to the initial contribution key provided for in Article 11 ESM-Treaty and calculated in Annex I.[57] The authorised capital stock shall be divided into paid-in shares and callable shares. The initial total aggregate nominal value of paid-in shares shall be EUR 80bn million. Shares of authorised capital stock initially subscribed shall be issued at par. Other shares shall be issued at par, unless the Board of Governors decides to issue them in special circumstances on other terms.

By signing the treaty ESM Members irrevocably and unconditionally undertake to provide their contribution to the authorised capital stock, in accordance with their contribution key in Annex I. They shall meet all capital calls on a timely basis in accordance with the terms set out in this Treaty. The Board of Governors may call in authorised unpaid capital at any time and set an appropriate period of time for its payment by the ESM Members (Art. 9 (1) ESM-Treaty). The liability of ESM Members is limited to the subscribed capital.

Concerning Germany this capitalization structure means that in the worst case EUR 190bn will be lost. This maximal loss will arise if the ESM has used the total amount of its capital stock to help distressed ESM-Member States to refinance ("roll") their sovereign debts, and if nevertheless these member states later one go into a default. However, history taught us, that sovereign defaults do not end with a zero payment. But haircuts of 50% to 70% are not unusual.[58] Hence, participating in the ESM creates the risk of a significant loss.

In a simplified way this risk may be described as follows: Helping a distressed ESM Member State by refinancing ("rolling") its debt, means first of all that

57 http://www.ft.com/intl/cms/s/0/52dcc61a-459f-11e1-93f1-00144feabdc0.html#axzz1mFeLpNbi

58 Sester, Beteiligung von privaten Investoren im Rahmen des ESM, WM 2011, 1057 ff. m. w. N.

ESM funds are used in a moment when the distressed ESM Member State can no longer roll its accumulated debt by issuing new sovereign bonds in the market without paying prohibitive high interest rates. Furthermore it means that the funds of the ESM are used to satisfy the old private sector creditors of distressed ESM Member States when their claims become due (basically when the bond maturity ends). In exchange for providing "emergency" liquidity to satisfy old creditors the ESM becomes the new creditor of the respective ESM Member State, but at conditions (interest rate, maturity etc.) that do not reflect the risk level of the debtor in the perception of the market. Last but not least it means that after "rolling" of the sovereign debt load (accumulate by the distressed ESM Member States) is completed, it is now the ESM (and its owners) that bear the full risk of a payment default. This mechanism creates nothing else but a bail out regime. But a bail-our regime established outside the TEU and the TFEU. Hence, it does not directly violate these treaties. In contrast, the new Art. 136 (3) TFEU is providing a legal basis in primary European law for the establishment of this innovative bail out regime. However, no one can seriously deny that such a bail out regime violates, at least, the spirit of Art. 125 (1) TFEU.

6. *Conclusion*

By reforming the EFSF and particularly by establishing the permanent ESM – not mentioning the new fiscal compact[59] – the Euro Area Member States have materially changed the nature of the Monetary Union and the European Union as such. Consequently, it is indispensable to integrated the ESM regime (and the fiscal compact) into the TFEU and clarify the relationship between the emerging Fiscal Union and the no bail out clause that seems to be no longer sacrosanct. Art. 136 (3) TFEU, which was introduced 2011 by means of the simplified Treaty revision process (Art. 48 (4) TFEU), does not provide a sustainable legitimisation of the bail out regime generated by the ESM-Treaty. Only a classical treaty change can re-establish legitimacy and guarantee consistency with primary EU law.

However, for the time being such a treaty change seems to be politically out of reach. Only after the current crisis will have been resolved in the perception of market participants and voters, will politicians dare to address this issue seriously. Hence, the indispensable treaty change will be part of the post crisis world. When designing the institutional setting for this post crisis world, one should not only repair institutional damages of the past, but pave the way for a true Fiscal Union. Without such a Union it will be impossible to reduce the

59 See http://www.european-council.europa.eu/media/579087/treaty.pdf

severe economical imbalances – as reflected for instance in the TARGET2 system[60] and the diverging borrowing conditions[61] – between the various Euro Area Member States which is widely considered to be the key for the long term existence of the Monetary Union. A Fiscal Union is not thinkable without a common sovereign debt instrument: the Eurobonds.

IV. Post crisis world: Fiscal union and eurobonds

How could a possible structure for the issuance of Eurobonds roughly look like? First of all a European Debt Agency (EDA) needs to be established. Such an agency could lend money to the 17 member states of the euro area on the basis of individual loans. In order to get the necessary funds it would issue bonds in the primary sovereign bond market. All obligations of the EDA under the bonds would be guaranteed by all 17 euro area member states to its full amount. Thereby Eurobonds would get a high credit rating, ideally AAA. In order to coordinate and supervise the borrowing practice of the involved states a joint fiscal policy institution must be established. Such an institution should be equipped with strict control and harsh intervention rights in national budget planning. Hence, national parliaments will loose part of their budget sovereignty or at least be forced to share it with a European institution if they breach certain solvency rules (e.g. Debt-to-GDP-ratios). I doubt that the people of the various Euro Area Member States will (ever) give legitimacy (by means of a referendum) to such a transfer, if such transfer will benefit the European Parliament in its current shape. What might be achievable on the medium run is a transfer of budget sovereignty to a new kind of European Parliament with a federal structure that might be constructed as a second chamber and composed by representatives of national parliaments or governments.[62]

Why could Eurobonds work? The public finances of the Euro Area as a whole look quite respectable, at least when compared with the US, Japan and the UK.[63]

60 See the controversial statement by Sinn, Das unischtbare Bail-out der EZB (http://www.oekonomenstimme.org/artikel/2011/06/das-unsichtbare-bail-out-der-ezb/)

61 ECB Financial Stability Review, June 2011, pp. 69–77

62 For thoughts that go in the a similar direction see for instance Peel, Germany and Europe: A very federal formula, Financial Times, 9. 2. 2012 (http://www.ft.com/intl/cms/s/0/31519b4a-5307-11el-950d-00144feabdc0.html).

63 IMF World Economic Outlook (April 2011).

% of GDP	2010	2011	2012	2013
US	91.6	99.5	102.9	105.6
UK	77.2	83.0	86.5	87.4
Japan	220.3	229.1	233.4	238.0
Euro Area	85.0	87.3	88.3	88.4

Furthermore by means of Eurobonds one could create the 2nd or 3rd largest sovereign bond market in the world. Such a market would be very liquid by its sheer size. And increased liquidity has a positive effect on bond yields.[64] Furthermore the enormous volume of such a market would make the life of downwards speculators much harder.

Consequently Eurobonds could contribute to a sustainable solution of the current imbalances, thereby allowing the ECB to focus on monetary policy only. But before the first Eurobond can be issued in a responsible manner by a future EDA there are some important preconditions to accomplish. First of all the heavily over-indebted countries need to downsize their debt level. Tough financial adjustment programmes and measures to increase global competitiveness (deregulation of labour markets) are necessary but not sufficient. Particularly countries like Greece and Portugal will need to develop a new creditable business model. However, in the case of these highly indebted countries haircuts on issued debt instruments will be indispensable before these countries can participate in the issuance of Eurobonds. Furthermore it is important to break the vicious circle of sovereign debt and bank restructuring. This can only be achieved if regulatory incentives for banks to buy sovereign bonds without a true risk evaluation are abolished.[65]

Last but not least safeguards against moral hazard must be established. One potential safeguard against moral hazard, expected particularly (but not only) from countries with a history of lax fiscal discipline, could be a veto right for AAA states. However, it does not seem to be very realistic that the 17 Euro Area Member States will ever agree on a veto right. Furthermore such a veto right for a small club of countries does not really fit into the basic concept of the EU where all Member States have equal rights and duties. And last but not least, it is doubtful if government of AAA states would really dare to make use of their individual veto-right when they should: The decisive moment will often come in good economic times when politicians feel comfortable to

64 See http://ec.europa.eu/economy_finance/consultation/stability_bonds/pdf/green-pepr-stability-bonds_en.pdf

65 Micossi/Carmassi/Peirce, CEPS Policy Brief, On the Tasks of the European Stability Mechanism, No. 235, 8 March 2011.

borrow excessively. Therefore an effective solution for the moral hazard problem can only be a market based solution.[66]

Such a solution is provided by the famous blue-bond-red-bond proposal developed by Delpla and von Weizsäcker.[67] Subject to that proposal the 17 Euro Area Member States can only finance part of their sovereign debt by means of Eurobonds: the blue bonds. The financing of the other part would depend on their individual ability to place red bonds in the primary sovereign bond market. The red bond volume of each Member State would be limited to 60% of its GDP. The 60%-limit is derived from the so-called Maastricht criteria[68] that almost all euro area member states are violating since years, even long before the crisis. This limit would guarantee that Eurobonds will (always) enjoy a AAA rating and at the same time it would set a strong incentive to take the Maastricht criteria finally serious. The effectiveness of this marked based safeguard against moral hazard ("lax fiscal discipline on the expenses of serious member states") could be enhanced by a standardized subordination clause to be included in all red bonds. Such a clause could oblige the issuer to use all its funds to fully serve its obligation under the blue bonds before using the remaining funds to serve its obligations under the red bonds. The subordination rule would become effective once a defined trigger event occurs (for instance the breach of a bond covenant related to a certain Debt-to-GDP-Ratio).

It is clear from the outset that such a concept would not work for states which currently have a Debt-to-GDP-Ratio of more than 100%. That is why these countries need to bring down their debt load before they can join the post crisis world of Eurobonds. However, all Euro Member States should work hardly and jointly to build this world, because only a Fiscal Union based among other on Eurobonds will be able to re-establish some kind of economic equilibrium between Euro Area Member States. Without such a new balance the Monetary Union will fall into parts and thereby harm all its Members and beyond. However, the future Fiscal Union should not eliminate competition (between member states and European regions). Instead it should use market forces to discipline "big spenders" among politicians all around Europe and not rely on shiny promises and constitutional debt brakes only. It is not about full equalization of taxation and borrowing conditions, but about stronger convergence. A federal structure like the one of Switzerland and its Cantons with a well functioning Monetary, Fiscal and Political Union, but a disciplining tax competition could serve as a model.

66 See in this context Issing, Die Währungsunion im Spannungsfeld von Politik und Ökonomie, EWS 2011, 257, 260.

67 Depla/von Wezsächer, brugelpolicybrief, issue 2010/03, The blue bond proposal, (http://www.bruegel.org/publications/).

68 Art. 126 (2) TFEU and Art. 1 Protocol on the Excessive Deficit Procedure http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0201:0328:EN:PDF